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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

11 January 1985

Yugoslavia: Financial Recovery Remains Elusive

Summary

Yugoslavia has given its creditors an optimistic forecast for recovery from its financial problems. Buoyed by improved export performance and current account surpluses in 1983-84, Belgrade believes that it can revive economic growth while reducing its debt through 1990. Yugoslav officials contend that the financial gains already made warrant lessened IMF supervision of the economy and a generous multiyear debt rescheduling from Western banks and governments. We believe Belgrade's expectations are unrealistic because the regime has done little to correct systemic problems that produced worsening inflation and deteriorating trade performace when past adjustment efforts were abandoned. Even with generous reschedulings and new credits, Yugoslavia could well face a financing gap by next year; debt servicing constraints will limit growth for the rest of the decade. [redacted] 25X1

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Performance in 1983-84

Yugoslavia has made progress in the past two years in recovering from its external financial crisis. At the beginning of 1983, Belgrade had all but exhausted its hard currency reserves, was some $500 million in arrears to foreign creditors, and was losing access to private financing. A package of new credits and debt refinancing from Western governments and banks in 1983, additional private and official debt rescheduling in 1984, and IMF standby loans helped stem the deterioration in Belgrade's financial position and cleared up arrears by the end of 1983. Moreover, Yugoslavia achieved much greater improvement in trade and current account performance than expected. Increases in hard currency exports of 13 percent in 1983 and 10 percent in 1984 and an 11 percent reduction in imports in 1983 cut the trade deficit from $3.8 billion in 1982 to an estimated $1.3 billion last year. Over this period, Yugoslavia's current account balance moved from a $1.6 billion deficit to an estimated $730 million surplus. [redacted] 25X1

The improvement in the external accounts has taken its toll on the domestic economy, but Belgrade can point to a few encouraging signs (see Table 1). Gross social product grew 2 percent last year following a 1.3-percent decline in 1983. Strong export gains helped boost industrial production 5 percent in 1984 following two years of near stagnation. IMF-mandated austerity measures cut investment by 20 percent over the past two years. The adjustment of private consumption has been much less severe. Withdrawals from dinar and private foreign exchange accounts--which have increased in value as a result of large dinar devaluations--and widespread moonlighting have helped keep consumption at higher levels than falling real incomes suggest. The major disappointment is that inflation has continued to accelerate despite efforts to curb domestic demand. [redacted] 25X1

Ambitous Plan for Debt Reduction

Encouraged by improved current account results, Belgrade contends that Yugoslavia can now afford a more expansionary economic policy. The Yugoslavs argue that the IMF's austerity program is provoking growing unrest and that some increase in investment and consumption is needed to sustain the country's recovery. [redacted] 25X1
Belgrade cannot continue to rely on decreases in domestic demand to improve the balance of payments but must achieve further gains through a significant increase in industrial production and exports and some increase in domestic consumption and investment. [redacted] 25X1

In a bid to ensure continued creditor support while

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loosening constraints on economic policy, Yugoslavia asked its private and official creditors in late 1984 for a generous multiyear rescheduling agreement and a reduction in IMF supervision. Belgrade argued that its improved financial performance entitled it to an arrangement similar to that received by Mexico. The Yugoslavs requested a rescheduling of loans maturing in 1985-88 for a period of 10 to 12 years at lower interest rates than those of the 1983-84 reschedulings. Belgrade alleged that such an arrangement would facilitate economic management by reducing the uncertainties associated with annual debt rescheduling negotiations. The Yugoslavs stated that they wanted to replace their IMF standby agreement with a modified Article IV consultation similar to that given Mexico. [redacted] 25X1

In conjunction with their request, the Yugoslavs presented their official and private creditors with a cash flow projection for 1985-90 (see Table 2). The forecast envisions a $3 billion reduction in hard currency debt and a $1.8-$2 billion increase in foreign exchange reserves over the period. Belgrade believes it can meet these targets with real export growth averaging 7 percent annually and current account surpluses of some $1.2 billion over the next several years. The Yugoslavs claim the projections are consistent with a 4-percent annual growth in GSP if domestic end uses increase by only 3.6 percent to allow growth in net exports. [redacted] 25X1

Both Western banks and governments have reacted coolly to the Yugoslav request. The official creditors rejected any multiyear arrangement because they did not want to establish a precedent for other Paris Club reschedulings and because they doubt Yugoslavia's financial performance has improved sufficiently to preclude new problems in the next few years. Western banks indicated that instead of a single multiyear arrangement they would refinance debts automatically at the beginning of each year in 1985-88 provided that the Yugoslavs met certain criteria. Both the governments and banks insisted on another IMF standby agreement for 1985 and left open the possibility of a less strict monitoring arrangement thereafter. Belgrade eventually yielded on the issue of a 1985 standby agreement and has negotiated the general outline of a new one-year program with the Fund. The Yugoslavs, however, remain committed to winning a multiyear rescheduling in upcoming negotiations with Western banks and governments. [redacted] 25X1

Reasons for Skepticism

Belgrade's forecast seems implausible because the regime has done little to correct the problems that prevented Yugoslavia from achieving growth with external balance in the past. The continuing increase in inflation shows that the Yugoslav economy

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remains in serious imbalance. Although IMF-mandated price increases to reduce government subsidies, easing of price controls, and devaluation of the dinar have contributed to inflation, the chief sources of inflation and excessive dependence on Western imports are rooted in the Yugoslav system. [redacted] 25X1

-- While the IMF has insisted on a tighter credit policy and the attainment of a positive real interest rate, Yugoslavia still lacks a capital market to ensure the efficient allocation of investment resources.

-- The workers' self-management councils retain the power to vote wage increases in excess of productivity gains.

-- Under Yugoslavia's highly decentralized political and economic system, local authorities can continue to follow policies of autarkic development that have led to irrational and redundant investment, subsidization of inefficient enterprises, and protection of local monopolies.

-- The lack of a functioning foreign exchange system impedes the flow of foreign resources to those producers that can make efficient use of these inputs. [redacted] 25X1

With these systemic problems untouched, an effort to expand domestic consumption and investment would worsen inflation and reverse recent gains in trade performance. Yugoslavia would simply add another phase to the cycle of stop/go adjustment that characterized economic performance throughout the 1970s. Whenever Belgrade lifted administrative controls that had slowed inflation and improved the balance of payments in order to resume rapid growth policies, inflation would accelerate and the current account would plunge deeper into the red. The key difference between Belgrade's current situation and the 1970s is that foreign lenders are now unlikely to extend the credits needed to finance import-led growth. Expansionary policies would soon produce large financing gaps, forcing a reduction in imports and a renewed contraction of domestic demand. [redacted] 25X1

Apart from the lack of systemic change, Belgrade's projections seem implausible because they rest on overly optimistic assumptions about export growth. The 7-percent target for growth in real exports implies an increase in Yugoslavia's market share in the OECD. While the export gains in 1983-84 increased Yugoslavia's share of the OECD market, further growth will be difficult to achieve. [redacted] 25X1

-- Because of the impact of inflation, Belgrade does not

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want to continue the large effective devaluations of the dinar against Western currencies that provided the main boost to exports in 1983-84. The continuing high rate of inflation in Yugoslavia and the close link between Yugoslavia's effective real exchange rate and export growth (see Figure 1) demonstrate, however, that continuing devaluations are needed to keep increasing Yugoslavia's market share in the OECD. 25X1

-- Export gains, particularly in 1983, also resulted from Yugoslavia's diversion of goods from soft-currency CEMA markets to the West. Yugoslavia has little scope left for this diversion because many of its soft currency exports are not marketable in the West and because the CEMA countries, particularly the USSR, may not tolerate growing Yugoslav deficits in bilateral trade.

-- Yugoslavia must also contend with growing competition from developing countries in OECD markets and Western protectionism. The West Europeans already have accused Yugoslavia of dumping some products, and further increases in market shares could provoke tougher restrictions. 25X1

Outlook

Our projections indicate that Yugoslavia's financial situation will remain much more tenuous through the remainder of the 1980s than the cash-flow forecast given by Belgrade to its creditors. Using the long-run relationship between the growth of Yugoslav exports and OECD growth, we estimate that hard currency exports will grow by about 2.5 percent annually in real terms (about 6.5 percent in nominal terms) through 1990, approximately equal to projected real growth in the OECD (see Table 3). Even holding real import growth for Yugoslavia equal to an average 2 percent (below the rate Belgrade claims it needs to meet its targets for growth of GSP and exports), the hard currency trade deficit rises steadily to $1.6 billion by 1990 instead of holding at roughly $1.3 billion as in the Yugoslav forecast. Because of higher interest payments than the Yugoslavs assume, we project that net services and transfers will fall to roughly $1.5 billion instead of rising to $2.3 billion. As a result, our estimates of Yugoslavia's current account surplus gradually fall after 1984, and a small deficit is possible by 1989. 25X1

If current account balances come close to the levels we project and Belgrade attempts to rebuild reserves to cover three months worth of imports as planned, Yugoslavia is likely to face financing gaps even with generous reschedulings and substantial new credits. If Yugoslavia reschedules all original maturities

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YUGOSLAVIA

INFLATION ADJUSTED EFFECTIVE EXCHANGE RATES AND REAL EXPORTS TO THE OECD

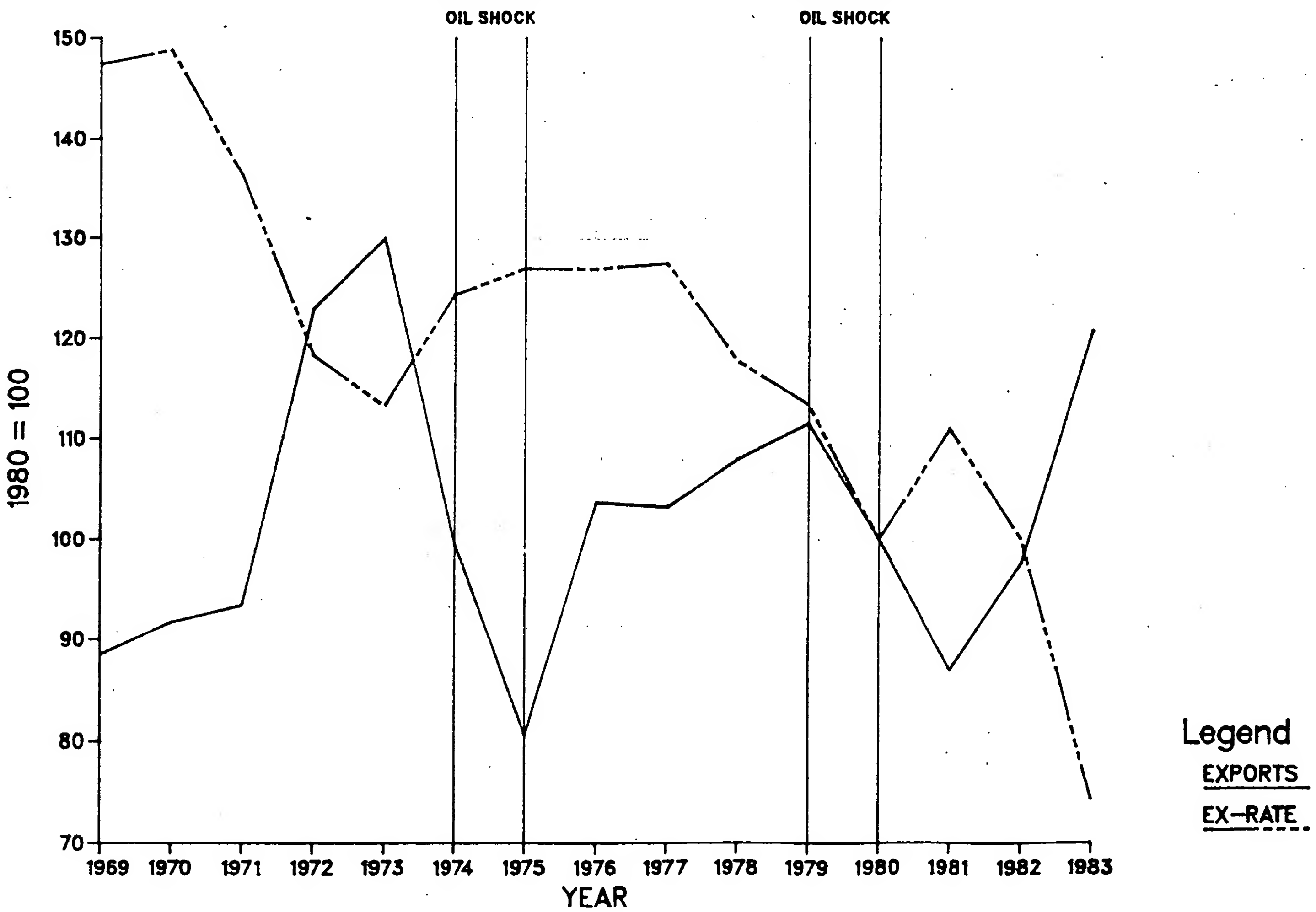

Table 1

ECONOMIC INDICATORS

	1978	1979	1980	1981	1982	1983	1984[a]
	(Percent Change from Previous Year)						
GNP (Social Production)[b]	6.9	7.0	2.3	1.5	0.3	-1.3	2.0
Industrial Output[b]	8.6	8.1	4.1	4.1	0.1	1.3	5.3
Industrial Labor Productivity	5.0	4.0	2.0	2.0	-3.0	-3.5	2.5
Gross Fixed Investment[b]	10.5	6.4	-5.9	-9.8	-6.2	-10.0	-10.0
Inflation	14.3	20.4	30.3	40.7	31.6	41.0	54.0
Unemployment[c]	12.0	11.9	11.9	11.9	12.9	14.5	15.0
Real Incomes	2.0	-1.9	-7.1	-10.2	-5.0	-10.0	-7.0

a Third Quarter Data

b Constant Prices

c Official Yugoslav Estimate

Table 2

Yugoslavia: External Debt and Payments Scenerio, 1983-1990
Millions of US Dollars, Unless otherwise indicated
Yugoslav Projections

Year	1983	1984	1985	1986	1987	1988	1989	1990
A) Financing Gap	0	0	0	0	0	0	0	0
B) Financing Requirement	-4038	-3600	-2950	-2900	-2800	-3300	-2600	-2600
a. Current Account Balance	299	730	1250	1400	1350	1090	1000	1070
i. Trade Balance	-1798	-1340	-1364	-1379	-1382	-1372	-1345	-1298
Exports	6271	6898	7657	8499	9434	10472	11624	12903
Imports	8069	8238	9021	9878	10816	11844	12969	14201
ii. Net Services and Transfers	2097	2070	2614	2779	2732	2462	2345	2368
Interest Payments (net)	-1489	-1650	-1750	-1650	-1500	-1500	-1450	-1260
Workers Remittances (net)	1599	1630	1600	1410	1260	980	600	400
Other	1987	2090	2764	3019	2972	3032	3195	3228
b. Repayment of MLT Loans	-2560	-3200	-3450	-3500	-3400	-3500	-3000	-3000
c. Repayment of ST Loans (net)	-670	-100	-200	-200	-100	-100	0	0
d. Credits to Foreign Countries	-157	-100	-250	-300	-350	-430	-480	-540
e. Credits (other)	0	-330	0	0	0	110	110	110
f. Reserves Target (increase -)	55	-600	-300	-300	-300	-470	-230	-240
g. Errors and Omissions	-1005	0	0	0	0	0	0	0
C) Borrowing Sources	4038	3600	2950	2900	2800	3300	2600	2600
a. MLT Credit Utilization	4038	3600	2950	2900	2800	3300	2600	2600
Total Rescheduling	1766	2190	1605	1512	1312	920	0	0
New Credits	2272	1410	1345	1388	1488	2380	2600	2600
D) Memoranda:								
a. Total Debt Outstanding	19000	19300	18600	17800	17100	16800	16400	16000
b. Nominal Export Growth (%)	13.0	10.00	11.00	11.00	11.00	11.00	11.00	11.00
c. Real Export Growth (%)	NA	NA	6.00	6.50	7.00	7.00	7.00	7.00
d. Nominal Import Growth (%)	-11.0	2.09	9.50	9.50	9.50	9.50	9.50	9.50
e. Real Import Growth (%)	NA	NA	4.50	5.00	5.50	5.50	5.50	5.50

Source: Official Yugoslav data provided to Western creditors.

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Table 3

Yugoslavia: External Debt and Payments Scenerio, 1983-1990
Millions of US Dollars, unless otherwise indicated
Baseline Scenario

Year	1983	1984[a]	1985[b]	1986[b]	1987[b]	1988[b]	1989[b]	1990[b]
A) Financing Gap	0	0	0	-372	-532	-1003	-257	-496
B) Financing Requirement	-4038	-3600	-3336	-3787	-4115	-4608	-2354	-1520
a. Current Account Balance	299	730	650	506	210	38	-85	-164
i) Trade Balance	-1798	-1340	-1438	-1465	-1511	-1546	-1584	-1622
Exports	6271	6898	7418	7923	8440	9002	9597	10230
Imports	8069	8238	8856	9388	9951	10548	11181	11852
ii) Net Services and Transfers	2097	2070	2088	1971	1721	1584	1499	1458
Interest Payments (net)	-1489	-1650	-1809	-1792	-1739	-1903	-1885	-1749
Workers Remittances (net)	1599	1630	1600	1410	1260	980	600	400
Other	1987	2090	2297	2353	2200	2507	2784	2807
b. Repayment of MLT Loans	-2560	-3200	-3544	-3924	-3979	-4268	-2116	-1199
c. Repayment of ST Loans (net)	-670	-100	0[c]	0[c]	0[c]	0[c]	0[c]	0[c]
d. Credits to Foreign Countries	-157	-100	-200	-150	-154	-160	-165	-170
e. Credits (other)	0	-330	0	0	0	110	110	110
f. Reserves (increases -)	55	-600	-242	-219	-192	-328	-98	-97
g. Errors and Omissions	-1005	0	0	0	0	0	0	0
C) Borrowing Sources	4038	3600	3336	3415	3583	3605	2097	1024
a. MLT Credit Utilization	4038	3600	3336	3787	4115	4608	2354	1520
Total Rescheduling	1766	2190	2003	1512	1312	920	497	124
New Credits	2272	1410	1333	1903	2271	2685	1600	900
D) Memoranda:								
a. Total Debt Outstanding[d]	19000	19300	19092	18955	19091	19431	19669	19990
b. Nominal Export Growth (%)	13.0	10.00	7.54	6.81	6.53	6.66	6.61	6.60
c. Real Export Growth (%)	NA	NA	2.54	2.31	2.53	2.66	2.61	2.60
d. Nominal Import Growth (%)	-11	2.09	7.50	6.01	6.00	6.00	6.00	6.00
e. Real Import Growth (%)	NA	NA	2.50	1.51	2.00	2.00	2.00	2.00

a) Estimated
b) Projected

c) Assumes short-term credit lines maintained.
d) Assumes involuntary lending or rescheduling covers financing gaps.
e) Amount of bilateral credits in 1989 and 1990 uncertain

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